United States Court of Appeals

for the Second Circuit

APPELLANT'S REPLY BRIEF

Signed

74-2434

IN THE UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

HICKS NURSERIES, INC.,

Appellee

v.

COMMISSIONER OF INTERNAL REVENUE,

Appellant

ON APPEAL FROM THE DECISION OF
THE UNITED STATES TAX COURT

REPLY BRIEF FOR THE APPELLANT

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Taxpayer's brief includes several contentions which require comment:

1. Rather than concentrating on finding support for its interpretation of the statute, taxpayer has chosen to distort the Commissioner's position through misstatements of the Commissioner's position and through numerous unsubstantiated references to "undisputed" or "conceded" points. These erroneous representations of allegedly undisputed or conceded propositions generally fall into two categories:

(a) First, having apparently found no authoritative support for its sweeping "override" theory (see Appellant's

Opening Br. 14, Appellee's Br. 5-14), taxpayer has attempted to create such support in several misstatements of the Commissioner's position. Taxpayer states (Br. 7):

> It is not disputed that the one shareholder rule of that subsection [1371(c)] was intended to override the general rule of section 1371(a) when the stockholders include married couples owning some or all of their stock concurrently or as community property. (Emphasis added.) 1/

From this overbroad proposition--which the Commissioner thoroughly disputes--taxpayer asserts (Br. 7) its conclusion that--

> Subsection (c), therefore, * * * ssarily takes precedence over subsect[illegible] Thus, whenever a husband and wife jo[illegible]n stock * * *, reference must be mad[illegible] to the overriding rule of subsection (c) * * *.

In response, the Commissioner is counting, not "creating," shareholders as taxpayer suggests (Br. 3), and in counting shareholders the Commissioner simply treats stock owned by a husband and wife individually as held by separate shareholders. Thus, as we pointed out in our opening brief (pp. 14-15, 24), in all cases where a husband and wife each own stock individually, they are treated as two shareholders. No change results from the addition of jointly owned shares in this situation, since no new shareholder is "added" (the shareholder status of

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1/ Elsewhere, taxpayer erroneously states in a similar vein (Br. 3):

> * * * it is not disputed that individual holdings are not to be counted as creating stockholders in addition to the "one stockholder" of the jointly owned stock.

the husband and wife having been established by virtue of their individual holdings).

The Commissioner also vigorously disputes the scope of taxpayer's override theory. (Br. 7.) We agree that when a husband and wife hold all their stock jointly and no stock individually, the one-shareholder rule of Section 1371(c) "overrides" the general rule of Section 1371(a) which would require them to be counted separately.[2/] However, when the husband or wife or both own some shares individually, in addition to joint shares, the one-shareholder rule of 1371(c) no longer prevails.[3/] This point was unequivocally made very clear in our opening brief, where we stated, for example (p. 6):

> Section 1371(c), however, did not change the rule for counting shareholders with respect to individually, separately, owned shares.

Taxpayer either fails to perceive the Commissioner's position, or, if it does, it fails to acknowledge the position. In any

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2/ See S. Rep. No. 913, 86th Cong., 1st Sess., pp. 1-2 (1959-2 Cum. Bull. 903).

3/ As we stated in our Opening brief (p. 12)--

> * * * the fact that the parties held jointly owned stock in addition to their separate, individually owned shares, does not, as a matter of law, change or otherwise affect the manner in which the separately owned stock should be counted (Emphasis added.)

The limited scope of the one-shareholder rule of Section 1371(c) advanced by the Commissioner is noted in 7 Mertens, Law of Federal Income Taxation (Rev.), §41B.06.

event, taxpayer cannot launch its override theory on the basis of repeated erroneous representations of the legal position of its adversary.

(b) In a second category of related erroneous representations, taxpayer would lead this Court to believe that the Commissioner applies the one-shareholder rule of Section 1371(c) in some circumstances in which a husband or wife owns stock individually (in addition to joint shares), but that the Commissioner ignores the Section 1371(c) one-shareholder rule in other situations when individual and joint shares are involved. This patently erroneous representation is advanced at least three times in taxpayer's brief. [4/] The contention

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4/ On page 10 taxpayer states:

> The Commissioner concedes that under synthesis established by the Regulation, the individual ownership of stock by one spouse is to be disregarded but denies that the individual holdings of the other spouse are also to be disregarded.

On page 15 taxpayer states:

> * * * the Commissioner concedes that subsection (c) applies to produce only one shareholder even though the husband and wife have an unequal interest in the corporation because one spouse holds stock in his or her individual name.

And, on page 19 taxpayer states:

> Here he is arguing that subsection (c) is applicable according to its terms where, in addition to the jointly held stock, only one spouse owns stock in his or her individual name but that there is an implied exception to the rule of subsection (c) where both a husband and wife own stock in their individual names.

is absolutely false. It has been the Commissioner's position that Section 1371(c) applies and causes one shareholder to be counted only when a husband and wife own stock jointly and no stock individually. (Appellant's Br. 6, 8, 13-15, 17, 23-25.) Referring to Section 1371(c) and the related Committee Report, we clearly stated (Br. 14-15)

> No mention is made of separately owned stock and, it follows, persons who own stock separately continue to be counted as separate shareholders--even if they may be husband and wife.

Thus, as we pointed out in our opening brief (pp. 24-25), when a husband and wife <u>both</u> own shares <u>individually</u>, in addition to joint shares, they are counted as <u>two</u> shareholders under the regulation by virtue of the fact that there are in fact, two persons, the husband and wife, who own shares individually. In effect, the joint shares are ignored and do not result in any increase in the number of shareholders, since no new shareholder is represented by the joint holdings. But, when only one spouse owns stock individually and the husband and wife own other shares jointly, they are counted as one shareholder, again by reason of the fact that only one spouse owns shares individually. Although "one shareholder" is counted in this hypothetical situation, that shareholder results from the fact that one spouse owns shares individually, and not by virtue of the "one-shareholder" rule of Section 1371(c), as taxpayer contends. (The Regulations do not require that a second shareholder be counted in that situation, since to do so would be again to use the joint shares to count a second person in the marital entity--

a result which, in our view, was not intended by Congress.) In sum, there is no inconsistency on the Commissioner's method of counting shareholders; individually held shares are always treated as held by separate shareholders.[5/]

2. In its analysis of the Regulations under Section 1371 taxpayer contends (Br. 3-4, 10-12) that the word "or" in the second sentence of Section 1.1371-1(d)(2) of the Regulations must be read in the combined conjunctive and disjunctive sense (as "and/or"), and that it cannot be read in the disjunctive sense only (as "or, but not both".) Without textual support, taxpayer alleges that the combined conjunctive and disjunctive use of "or" is "normal" usage (Br. 11) and is its "usual meaning" (Br. 4), and that the Commissioner's disjunctive use of "or" is "abnormal" (Br. 4, 12.) But this characterization is quite without support; the regulation which permits "or" to be read as "and/or" requires as a condition to such a meaning that the context "requires" it. (Treasury Regulations on Income Tax (1954 Code), §1.368-2(h)) Taxpayer, however, fails to meet its burden of showing a context requiring the combined conjunctive/disjunctive reading of "or," and instead argues the negative

5/ Actually, it is the taxpayer which is advancing an illogical interpretation of the statute, as the result in this case below clearly shows. When Mr. and Mrs. Hicks, for example, each held shares individually and no shares jointly, they were counted by taxpayer as two shareholders for purposes of Section 1371(a). By retaining all but two of their separate shares, and transferring one share each into joint tenancy, these two shareholders, under taxpayer's interpretation of the statute, were transmogrified into one shareholder. It is possible, under taxpayer's interpretation, to add a joint share to a husband's and wife's separate holdings and thereby reduce the number of shareholders.

premise, i.e., that the context does not require only the disjunctive meaning, attempting to shift the burden of showing a required context onto the Commissioner. (Br. 11-12.)

3. Taxpayer further contends that any doubt as to the meaning of the provisions of Section 1371(a) and (c) should be resolved in its favor, relying on Gould v. Gould, 245 U.S. 151 (1917), which considered the issue whether alimony received by a wife was taxable as income to her under an early tax statute. More recent Supreme Court authority would appear to reject the presumption in the taxpayer's favor announced in Gould. In White v. United States, 305 U.S. 281 (1938), which considered the taxation of liquidating distributions, the Court perceived the controlling question to be one of the legislative intent in enacting a provision. The Court stated (p. 292):

> We are not impressed by the argument that, as the question here decided is doubtful, all doubts should be resolved in favor of the taxpayer. It is the function and duty of courts to resolve doubts. We know of no reason why that function should be abdicated in a tax case more than in any other where the rights of suitors turn on the construction of a statute and it is our duty to decide what that construction fairly should be. Here doubts which may arise upon a cursory examination of §101 and 115 disappear when they are read, as they must be, with every other material part of the statute, Hellmich v. Hellman, supra, 237, and in the light of their legislative history. Moreover, every deduction from gross income is allowed as a matter of legislative grace, and "only as there is clear provision therefor can any particular deduction be allowed . . . a taxpayer seeking a deduction must be able to point to an applicable statute and show that he comes within its terms." New Colonial Ice Co. v. Helvering, 292 U.S. 435, 440.

We submit that Section 1371(c) is sufficiently clear on its face so as not to require resort to legislative history and other aids of statutory construction. But if doubt exists as to the meaning of its provisions, it should be resolved with reference to legislative intent and other aids discussed below.

Taxpayer also contends that the Subchapter S provisions are in the nature of remedial or relief provisions, and that the one-shareholder rule of 1371(c) should therefore be liberally construed in its favor.[6/] To be sure, the Subchapter S provisions have certain remedial characteristics, but it does not follow that these provisions should be liberally construed in favor of taxpayer. The Subchapter S provisions operate as an exception to the general rule treating corporations as separate taxable entities. (Sec. 11(a), Internal Revenue Code of 1954 (26 U.S.C.))[7/] It is well established that tax provisions which provide exceptions

6/ This Court's decision in Hollander v. United States, 248 F. 2d 247 (1957), relied on by taxpayer (Br. 22), is clearly distinguishable. Hollander involved a retroactive relief provision which, due to the statute of limitations, would not have benefited the intended taxpayers unless the statute of limitations was judicially waived in those cases. The statute of limitations was held not a bar to recovery in that case. In any event, Hollander, in effect, was overruled in United States v. Zacks, 375 U.S. 59 (1963), involving a different retroactive relief provision but an identical statute of limitations problem.

7/ SEC. 11. TAX IMPOSED.

(a) Corporations In General.--A tax is hereby imposed for each taxable year on the taxable income of every corporation. The tax shall consist of a normal tax computed under subsection (b) and a surtax computed under subsection (c).

* * *

should be strictly construed according to their terms,[8/] a rule particularly true with respect to the various express requirements of obtaining and retaining preferential Subchapter S status.[9/] Accordingly, any doubt as to the proper meaning of the provisions of Section 1371(a)(1) and (c) should not simply be resolved, automatically, in taxpayer's favor.

4. In a further effort to justify a decision in its favor, taxpayer argues (Br. 22-23) that it was not engaging in any "tax planning" or tax "avoidance," and that it should not be penalized for merely trying to comply with the Subchapter S requirements. But the issue in this case involves the correct interpretation of the statute, and the above subjective considerations offered by taxpayer have no relevance to this determination. In any event, it can fairly be inferred from

8/ See, e.g., Zillmer v. United States, 233 F. 2d 912 (C.A. 7, 1956), and Senft v. United States, 319 F. 2d 642 (C.A. 3, 1963). See also 1 Mertens, Law of Federal Income Taxation (Rev.), §§3.05 through 3.09.

9/ See Old Virginia Brick Co. v. Commissioner, 367 F. 2d 276 (C.A. 4, 1966) (involving the Section 1371(a)(2) limitation on non-individual shareholders); Pacific Coast Music Jobbers, Inc. v. Commissioner, 457 F. 2d 1165 (C.A. 5, 1972) (involving the Section 1371(b) election requirement); Pollack v. Commissioner, 392 F. 2d 409 (C.A. 5, 1968), and Henderson v. United States, 245 F. Supp. 782 (M.D. Ala., 1965) (both involving the one class of stock limitation of Section 1371(a)(4)); Marshall v. Commissioner, 35 A.F.T.R. 2d 526 (C.A. 10, Jan. 7, 1975); and Zychinski v. Commissioner, 34 A.F.T.R. 2d 6249 (C.A. 8, Nov. 25, 1974) (both involving the 20 percent passive investment income limitation of Section 1372(e)(5); and Barnes Motor and Parts Co. v. United States, 309 F. Supp. 298 (E.D. N.C., 1970) (involving the restriction on members of an affiliated group).

the record that tax considerations may well have been the underlying reason for the Subchapter S election. Taxpayer elected Subchapter S status when it was in the process of selling, on the installment basis, various parcels of real property from which it received gains (reported as capital gains) of over $1,000,000 during the years in issue. (Exs. 1A-4D.) Under the Subchapter S election, these long-term gains would not be taxed to the corporation.[10/]

CONCLUSION

For the above reasons, as well as those set forth in our opening brief, the decision below is incorrect and should be reversed.

Respectfully submitted,

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FEBRUARY, 1975.

10/ This use of the Subchapter S provisions to by-pass the tax normally imposed on a corporation's previously earned capital gains has been described by Congress as tax "manipulation" and as a "device to avoid a capital gains tax," which led to the subsequent enactment of Section 1378 of the Code. See S. Rep. No. 1007, 89th Cong. 2d Sess., pp. 2, 6-7 (1966-1 Cum. Bull. 527-528, 531). (Section 1378, which is not applicable to taxpayer's years 1964 through 1966 in issue, taxes certain capital gains to a corporation--in general, those in excess of $25,000 per year--notwithstanding its Subchapter S status). (Section 1378 was added by Section 2, Act of April 14, 1966, P.L. 89-389, 80 Stat. 111, effective in tax years beginning after April 14, 1966.)

CERTIFICATE OF SERVICE

It is hereby certified that service of this reply brief has been made on opposing counsel on this 18th day of February, 1975, by mailing four copies thereof, in an envelope, with postage prepaid, properly addressed to them as follows:

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February 18, 1975

Address Reply to the
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5-13086

A. Daniel Fusaro, Esquire
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Re: Hicks Nurseries, Inc. v. Commissioner
(C.A. 2 - No. 74-2434)

Dear Mr. Fusaro:

We are transmitting herewith for filing with your Court on behalf of the Appellant in the above-entitled case twenty-five copies of the reply brief.

We are forwarding four additional copies to counsel for the Appellee, together with a copy of the letter.

Sincerely yours,

SCOTT P. CRAMPTON
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